

HKFRS / IFRS UPDATE 2020/06

May 2020

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THE IASB ISSUED AMENDMENTS TO IFRS 16: COVID-19 RELATED RENT CONCESSIONS



Further to our *Update 2020/04* to give you a heads up on the proposed amendments to IFRS 16 allowing practical expedient for lessees to account for COVID-19 related rent concession, the IASB finalised the amendments on 28 May 2020. Based on the feedbacks received on the exposure draft, the IASB finalised the amendments with some changes to the proposed amendments as in the exposure draft. On the other hand, despite some feedbacks suggesting the IASB to extend the practical expedient to lessors, the IASB did not take up those suggestions. This means if the rent concession meets the definition of lease modification, lessors should follow the existing requirements in IFRS 16 to account for the rent concession as a lease modification.

The amendments to IFRS 16 are effective for annual reporting periods beginning on or after 1 June 2020, with earlier application permitted. **Application is also permitted in financial statements of earlier periods not yet authorised for issue at 28 May 2020.** An example is 31 March 2020 year-end financial statements not yet authorised for issue at 28 May 2020.

HKFRS financial statements preparers are reminded that although it is very likely the HKICPA would publish the same amendments to HKFRS 16, application of the practical expedient to HKFRS financial statements is not yet available until the HKICAP publishes the amendments to HKFRS 16. The amendments to HKFRS 16 is expected to come very soon.

Appended to this *Update* is a newsletter published by BDO Global which explains the practical implications of the amendments with examples, and also includes a flowchart to demonstrate how the criteria to utilise the practical expedient are evaluated. If you are a HKFRS financial statements

preparer, the information in the newsletter would help you assess whether you qualify for the expected practical expedient in HKFRS 16 as to speed up your financial statements preparation process.

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APPENDIX

**IASB ISSUES AMENDMENTS TO IFRS 16:
COVID-19 RELATED RENT CONCESSIONS**

INTERNATIONAL FINANCIAL REPORTING BULLETIN
2020/08

BACKGROUND

On 28 May 2020, the IASB issued amendments to IFRS 16, which provide relief for lessees in accounting for rent concessions granted as a direct consequence of COVID-19.

THE ISSUE FOR LESSEES

The IASB has received feedback that lessees are experiencing significant operational difficulty in applying the existing requirements of IFRS 16 for rent concessions. Many types of rent concessions provided to lessees as a result of COVID-19 would meet the definition of a lease modification, which require lessees to remeasure the lease liability based on the revised consideration using a revised discount rate. The IASB noted while this requirement is not typically onerous, it becomes challenging to apply for lessees with potentially hundreds or thousands of leases, especially when entities are experiencing significant other operational disruptions due to the effects of COVID-19. Entities are also required to assess whether each change to a lease contract meets the definition of a lease modification, which adds another layer of complexity.

The IASB issued an exposure draft in April 2020, which proposed amendments to IFRS 16 to provide operational relief for lessees. Based on the feedback received on the exposure draft, the IASB decided to amend IFRS 16, with some changes being made to the original proposals in the exposure draft.

THE AMENDMENTS

IFRS 16 has been amended to:

- (a) Provide lessees with an exemption from the requirement to determine whether a COVID-19-related rent concession is a lease modification;
- (b) Require lessees that apply the exemption to account for COVID-19-related rent concessions as if they were not lease modifications.

The criteria that must be satisfied for a rent concession to qualify for the practical expedient are summarised in the flowchart below. Explanation of the criteria and the practical implications of applying the practical expedient follow afterwards.

LESSOR ACCOUNTING

The IASB did not amend the accounting requirements for lessors. Despite every concession provided to a lessee having a corresponding effect on the lessor, the IASB noted that the circumstances differ for lessors. Lessor accounting did not change substantially as a consequence of the adoption of IFRS 16, and many concessions offered to lessees relate to leases that are accounted for as operating leases by lessors, which have less complex requirements than lessee accounting. In addition, in contrast to the requirements for lessees, IFRS 16 does not contain accounting requirements for lessors when changes to lease payments are not treated as modifications. Consequently, as noted in IFRS 16.BC240A, the IASB would have had to develop new requirements, which would have adversely affected the interaction of the lessor accounting requirements in IFRS 16 and related requirements in IFRS 9 *Financial Instruments* and IFRS 15 *Revenue from Contracts with Customers*, and could have had unintended consequences particularly given the speed with which changes would have needed to have been made.

The Staff Q&A issued by the FASB extended the relief in US GAAP to lessees and lessors, therefore, the IASB's approach differs from FASB's in this regard.

STATUS

Final

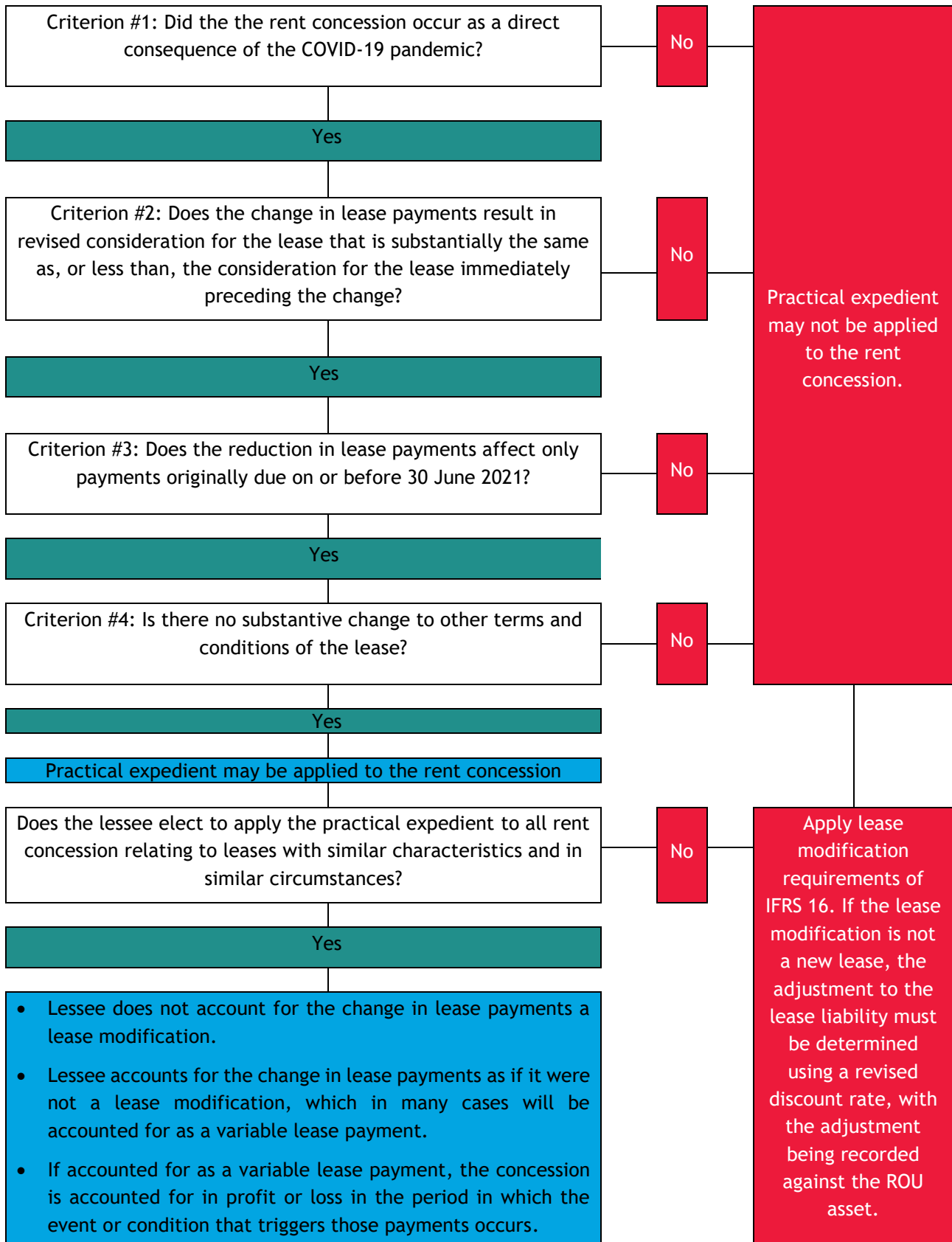
EFFECTIVE DATE

Mandatory for annual reporting periods beginning on or after 1 June 2020. Earlier application is permitted, including in financial statements not yet authorised for issue at 28 May 2020.

ACCOUNTING IMPACT

Significant operational relief for lessees in accounting for modifications to lease contracts as a consequence of COVID-19.

OVERVIEW OF THE AMENDMENTS TO IFRS 16



CRITERION #1: DIRECT CONSEQUENCE OF COVID-19

A rent concession must occur ‘as a direct consequence of the COVID-19 pandemic’ for the practical expedient to be applied. The amendments do not provide further guidance on how this criterion should be evaluated. Entities must apply judgment in determining whether a rent concession provided by a lessor is a direct consequence of the COVID-19 pandemic.

Some concessions may be provided for reasons that relate to the pandemic, but are not a ‘direct consequence’. For example, a lessor reducing the lease payments relating to underlying assets used in oil and gas extraction while the price of oil remains below a specific level would not occur ‘as a direct consequence’ of the pandemic. Such a reduction would also fail to satisfy criterion #3, as the reduction in lease payments would not be restricted to that specific time period.

In general terms, criteria #2-4 are more specific than criterion #1, therefore, rent concessions that satisfy criteria #2-4 may very often be deemed to satisfy criterion #1. Many rent concessions provided during the pandemic relate to closures of retail locations or offices as a result of government mandated social distancing or ‘lockdown’ orders, which would generally be considered to have occurred as a direct consequence of the pandemic.

CRITERION #2: REVISED CONSIDERATION

The rent concession must result in revised consideration for the lease that is substantially the same, or less than, the consideration for the lease immediately preceding the change.

This criterion will be simple to assess in practice where the fixed nominal cash flows (i.e. cash flows on an undiscounted basis) are reduced. For example, if the rent concession reduces the nominal cash flows by \$300 in comparison to the terms of the lease prior to the change, it would satisfy this criterion.

Additional judgment is required if the rent concession increases the nominal cash flows of the lease. For example, if a rent concession defers 3 payments of monthly rent of \$100 for a period of 12 months, the lessor and lessee may agree to increase the nominal cash flows to say, \$105 per month for the payments that are deferred to compensate the lessor for the time value of money. This may be more common in jurisdictions with higher rates of inflation where the time value of money is more significant, and when the deferral of payments is for more than an insignificant period of time.

The amendments are unclear as to whether ‘revised consideration’ must be evaluated based on nominal (i.e. undiscounted) or discounted cash flows, and if discounted cash flows are permitted, the basis on which the present value calculation should be performed (e.g. which discount rate should apply and whether total consideration in the lease is evaluated or only remaining consideration as at the time of the rent concession).

The basis for conclusions to the amendments notes that a change that is more than an insubstantial increase in total payments could not result solely from a COVID-19 related rent concession, except to the extent the increase reflects the time value of money. Therefore, if the nominal cash flows have increased, it would appear to be appropriate for entities to assess criterion #2 by determining whether the increase reflects the time value of money. Other increases in consideration, such as penalties that are included in the deferral, would cause this criterion to not be satisfied.

CRITERION #3: AFFECTS LEASE PAYMENTS ORIGINALLY DUE ON OR BEFORE 30 JUNE 2021

The rent concession must reduce lease payments originally due on or before 30 June 2021. This criterion is assessed for the rent concession as a whole, and it is written as a strict rule, therefore, a rent concession that reduces lease payments in any way past 30 June 2021 will disqualify the rent concession from the application of the practical expedient.

For example, if a rent concession resulted in reduced lease payments from 30 June 2020 to 31 August 2021, the entire rent concession would fail this criterion and the practical expedient would be unavailable. Rent concessions are not permitted to be 'sub-divided' into a portion that satisfies the criterion (i.e. 30 June 2020 - 30 June 2021) and a portion that does not satisfy the criterion (1 July 2021 - 31 August 2021). The criterion is assessed for the rent concession in its entirety.

CRITERION #4: NO SUBSTANTIVE CHANGE TO OTHER TERMS AND CONDITIONS

The rent concession must not contain other substantive changes to other terms and conditions of the lease, other than the changes permitted by the other criteria in the practical expedient. The IASB decided to include this criterion to ensure that only rent concessions directly related to the pandemic would qualify for the use of the practical expedient, and not other modifications to lease contracts that happen to be negotiated at the same time as other rent concessions.

Extensions to the lease term, the introduction or modification of lessee and/or lessor options, or other changes in the scope of leases would disqualify the rent concession from the application of the practical expedient. Instead, the lessee would be required to apply the requirements applicable to lease modifications, if the change meets the definition of a lease modification. IFRS 16.BC205D(c) clarifies the Board's conclusion, and notes that a three month rental holiday before 30 June 2021, followed by three additional months of substantially equivalent payment at the end of the lease would not constitute a substantive change to other terms and conditions of the lease. A staff paper from the IASB's 15 May 2020 meeting discusses this example and that the IASB intended to capture within the scope of the practical expedient a simple concession that essentially replaces the period of the rent concession with an equivalent period at the end of the lease and with substantially equivalent payments.

As an example of an arrangement which would not satisfy the criterion, if a lessor offered to reduce the lessee's monthly rent for office space for a period of time, but only on the condition that it reduced its office space from 5,000 square feet to 3,000 square feet, this would be a substantive change to other terms and conditions, and therefore, the practical expedient would be unavailable for that rent concession.

EFFECT OF APPLYING THE PRACTICAL EXPEDIENT

If a rent concession satisfies all criteria, the practical expedient is available to be applied, however, its application is not mandatory. While the amendments to IFRS 16 do not explicitly specify whether it may be applied on a lease by lease basis, all accounting policies relating to leases in the scope of IFRS 16 are subject to the requirement in paragraph 2 of IFRS 16, which requires an entity to apply IFRS 16 consistently to contracts with 'similar characteristics and in similar circumstances'. This point is confirmed in IFRS 16.BC205C. Therefore, an entity should apply (or not apply) the practical expedient consistently for similar leases. If an entity applies the practical expedient to some types of leases but not others that meet the criteria for its application, then additional disclosure is required (see disclosure section of this publication below).

By utilising the practical expedient, the lessee does not account for a rent concession as a lease modification, regardless of whether the rent concession otherwise would meet the definition of a lease modification.

The amendments do not specify which requirements of IFRS 16 should be applied in place of the lease modification guidance. However, in many situations the requirements of IFRS 16.38(b) will apply, which require that variable lease payments not included in the measurement of the lease liability are included in profit or loss in the period in which the event or condition that triggers those payments occurs. A reduction in the consideration of a lease that is a rent concession satisfying the criteria for application of the practical expedient will therefore often be accounted for as a 'negative variable payment'. The basic application of the practical expedient in comparison to the lease modification requirements of IFRS 16 is demonstrated below.

Example - rent abatement

Entity A leases retail space from Entity B. As at 31 May 2020, Entity B grants Entity A a 1 month rent abatement, where rent of CU 100 that would otherwise be due on 1 June 2020 is unconditionally waived. This rent abatement was not part of the original terms and conditions of the lease. The rent abatement is being granted because Entity A had to close its retail location due to government mandated lockdown procedures. The rent concession satisfies the criteria to apply the practical expedient because:

- (1) It is a rent concession occurring as a direct consequence of the pandemic;
- (2) It results in revised consideration that is less than the consideration for the lease immediately preceding the change;
- (3) It reduces lease payments originally due on or before 30 June 2021; and
- (4) There is no substantive change to other terms and conditions of the lease.

The rent concession meets the definition of a lease modification, and it would be accounted for as such if the practical expedient is not elected by Entity A. The rent concession is a lease modification because it is a change in consideration for a lease that is not part of the original terms and conditions of the lease.

	Practical expedient not applied - lease modification accounting (IFRS 16.39-43)	Practical expedient is applied - variable lease payment accounting (IFRS 16.38(b))
Effect on lease liability	Reduced to reflect the revised consideration	Reduced to reflect the revised consideration
Effect on discount rate	The total revised, remaining consideration is remeasured using an updated discount rate as at the effective date of the lease modification	No change in discount rate
Effect on right-of-use asset	The offsetting adjustment is recorded against the carrying value of the right-of-use asset	No effect
Effect on profit or loss	None as at the time of modification; will result in modified finance expense and depreciation in subsequent periods	The offsetting adjustment is recorded in profit or loss

Applying the practical expedient relieves the lessee from having to assess each rent concession to determine whether it meets the definition of a lease modification. It also simplifies the calculations that are prepared by the lessee, since it does not require a revised discount rate. Finally, the practical expedient results in the benefit of the rent concession being reflected in profit or loss in the period in

which the event or condition that triggers the revised consideration occurs, rather than being reflected in future periods as revised finance expense and depreciation of the right-of-use asset.

DISCLOSURE

An entity that applies the practical expedient must disclose:

- (a) That it has applied the practical expedient to all rent concessions that meet the criteria, or if not applied to all such rent concessions, information about the nature of the contracts to which it has applied the practical expedient (see analysis above concerning the consistent application of the practical expedient); and
- (b) The amount recognised in profit or loss to reflect changes in lease payments that arise from COVID-19-related rent concessions. Therefore, rent concessions accounted for as negative variable lease payments in profit or loss must be disclosed separately from the effect of other variable lease payments included in profit or loss (e.g. rent payable based on sales occurring at a retail location).

EFFECTIVE DATE AND TRANSITION

The amendments are effective for annual reporting periods beginning on or after 1 June 2020, with earlier application permitted. Unlike most amendments to IFRS, application is also permitted in financial statements of earlier periods not yet authorised for issue at 28 May 2020.

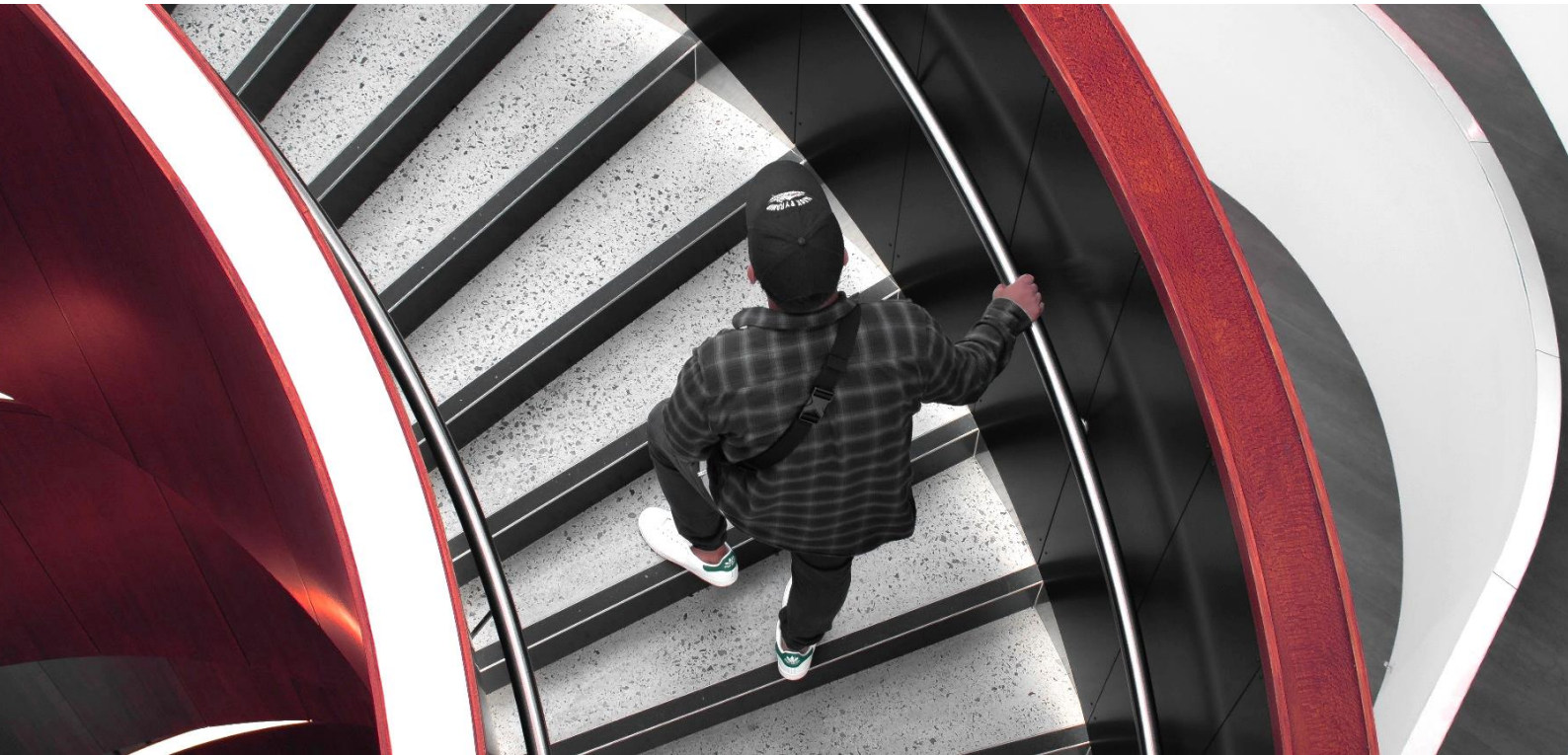
For example, as at 31 May 2020, if an entity applies IFRS as issued by the IASB and was still preparing its financial statements for the period ended 31 March 2020, it could apply the amendments and utilise the practical expedient for rent concessions that occurred as at 31 March 2020 or earlier, assuming they satisfied the criteria. Therefore, the amendments are effective on a retrospective basis, if an entity wishes to do so, but they are not mandatory until 1 June 2020.

For entities that do not apply IFRS as issued by the IASB (e.g. IFRS as endorsed by the European Union or based on the endorsement of other national standard setters), application of the amendments will be delayed until the applicable endorsement or approval process occurs.

CONCLUSION

The amendments to IFRS 16 simplify the accounting requirements for lessees. However, a lessee is still required to assess each rent concession against the criteria established by the practical expedient and determine the appropriate adjustment to the lease liability. While the work effort is certainly less than what would be required if a lessee also had to determine whether the requirements for lease modification accounting were applicable, significant work effort may still be required for lessees with a large volume of leases.

Lessors may not apply the practical expedients, therefore, lessors must determine an appropriate approach applying the existing requirements of IFRS.



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